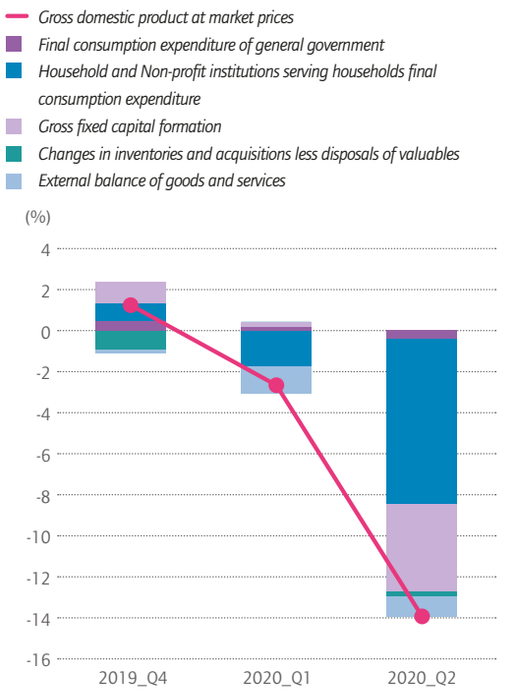
Anatomy of a recession: developments in aggregate demand and its components

Figure 1.15 shows how the contribution of different components of aggregate demand to GDP growth changed year-on-year from the fourth quarter of 2019 to the second quarter of 2020 (for which the latest data are available). The evolution of GDP is shaped by the sum of the evolution of its components, which here are measured as different types of expenditure (on final consumption, investment, net exports and so on). This breakdown is important for understanding what drives the evolution of GDP and provides indications to policymakers as to where they should be focusing their policy interventions to mitigate a shock.

In the final quarter of 2019, nominal year-on-year GDP growth stood at 1.24%, driven by growth in investment (1.06pp year-on-year) and final consumption of households (0.83pp). In the first quarter of 2020, year-on-year nominal GDP shrank by 2.66%, with households' final consumption and the trade balance (that is, the difference between exports and imports) driving that development with year-on-year reductions of 1.73pp and 1.34pp respectively. In the second quarter of 2020, when year-on-year nominal GDP dropped by 14%, it was both the final consumption of households and investment that caused this drop, by falling by 8pp and 4pp respectively. The negative contribution of households' final consumption and of the trade balance reflect the reduced consumption spending of households domestically and abroad, as economies across Europe and the main trading partners were put into artificial comas. As economic activity in all but the essential sectors was put on hold, unemployment increased, as did uncertainty about near-future income and economic prospects. Although income losses due to unemployment can to an extent be cushioned by unemployment benefits, neither the income replacement itself nor the coverage of those out of employment, especially of those in non-standard forms of employment, was complete. Moreover, the closing down of sectors considered 'non-essential' meant that consumption opportunities were no longer available. This delay in consumption, together with uncertainty about incomes and the future economic situation, can trigger precautionary saving and stall investment decisions, which in turn serves to reduce GDP and affects countries' ability to provide unemployment benefits and financial aid for companies in crisis.

It is worth noting that in the second quarter of 2020, the general government final consumption expenditure, which measures the benefits *in kind* that a government pays out to society and households, excluding benefits *in cash*, contributed to the reduction of GDP only marginally. The extent to which governments reduced the provision of benefits in kind was far lesser than the reduction in final consumption of households, as many were essential (e.g. healthcare, defence, policing), inelastic or amenable to telework (education, public administration).

Figure 1.15 Contribution to nominal GDP growth of final consumption, gross fixed capital investment, inventories and external balance (p.p. change compared to same period in previous year)

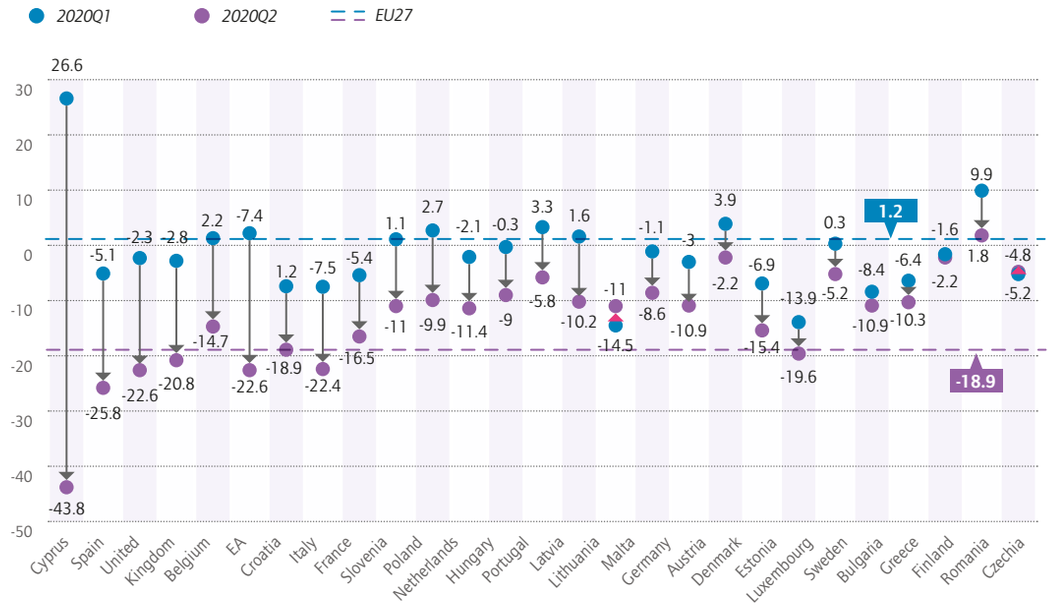


Source: Eurostat NAMQ_10_GDP CON_PPCH_SM.

Collapsing investment in an uncertain environment

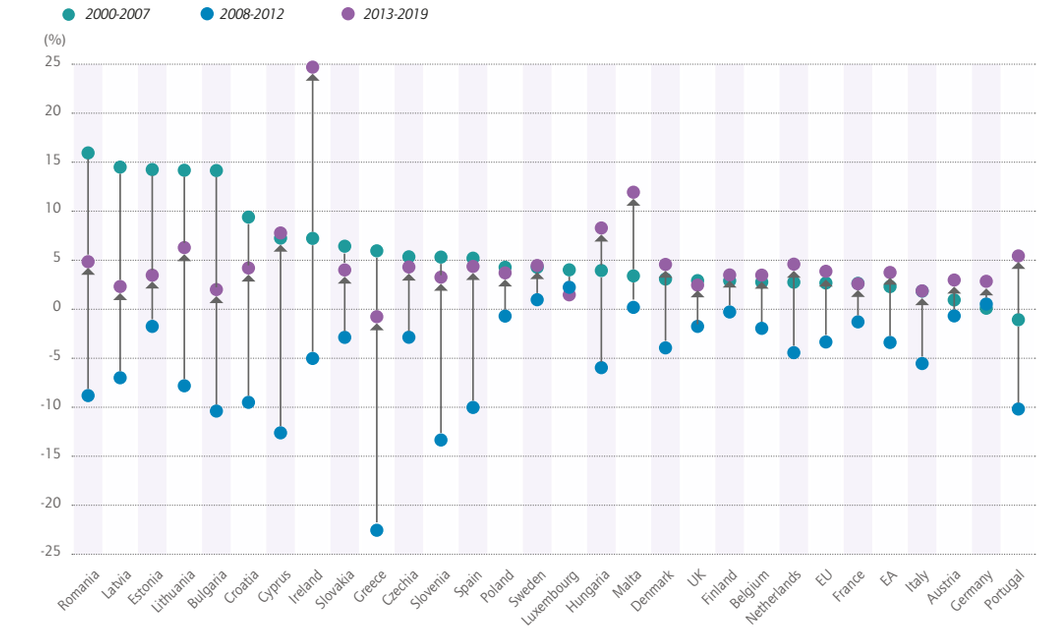
Figure 1.16 shows how investment (gross fixed capital formation) changed year-on-year in the first two quarters of 2020 in the EU27, Member States and the UK. Figure 1.15, meanwhile, shows how the average annual growth rate in real gross fixed capital formation evolved in 2000-2007 (prior to the Great Recession), 2008-2012 (the Great Recession), and 2013-2019 (the recovery period up to the pandemic) in the same countries. Investment indicates the rate at which capital accumulates. Capital accumulation allows labour productivity to grow. In the second

Figure 1.16 Quarterly real gross fixed capital formation (change compared to same period in previous year), EU Member States and the UK, 2020_Q1 and Q2



Source: Eurostat NAMQ_10_GDP CLV_PCH_SM series
Note: Ireland has been excluded due to large fluctuations between data points.

Figure 1.17 Average annual growth rate of real gross fixed capital formation, EU27 member states and the UK, 2000-2007, 2008-2012, 2013-2019



Source: Own calculations using the AMECO OIGT series.

quarter of 2020, investment dropped on average by 15.4% in the EU and 17.1% in the euro area. The variation at the Member State level was very wide, ranging from -44% in Cyprus to a meagre but still positive 0.6-0.7 % in Romania and Czechia. These were also the only Member States that registered positive quarterly growth in real investment.

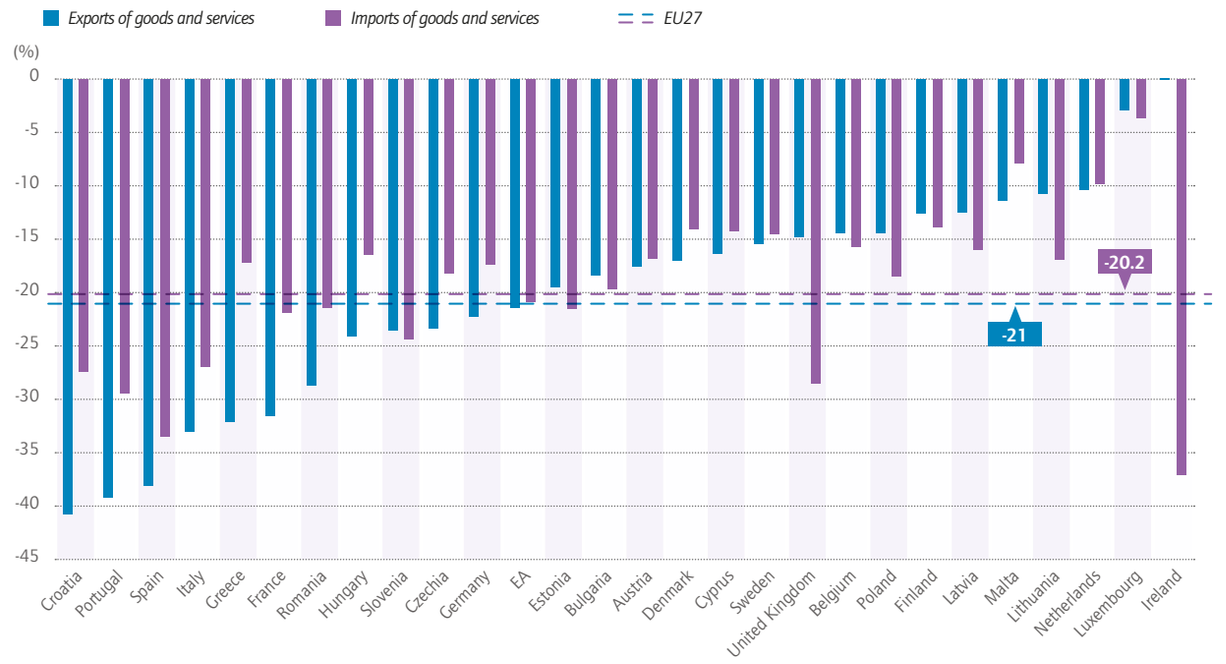
This dramatic drop in investment in most EU Member States follows over a decade of weak or even negative investment growth. As Figure 1.15 shows, the average annual growth rate of real investment was lower in 2008-2012 than in 2000-2007 in all Member States except for Luxembourg and Germany, where it was 0.5%. During the recovery period of 2013-2019, the average annual growth rate of real investment was lower than in 2000-2007 in many Member States and about the same but still low in many others. Weak real investment growth can at least partly explain the persistently weakening real labour productivity growth presented in Figure 1.8. In turn, the current situation of great uncertainty over economic prospects is bound to have a detrimental effect on investment until the pandemic is under control.

This is even more worrying when we consider that fostering a transition to a climate-neutral socioeconomic model is currently at the top of the EU's economic agenda, a venture which will require a significant investment effort. According to the European Commission (European Commission

2020), reaching the EU 2030 climate and energy targets of reducing carbon emissions by 40% of what they were in 1990, which were still in place in January, would require *additional* annual investment to the tune of €260 billion (see also Chapter 3 in this volume). Currently, however, both the European Commission and the European Parliament have been pushing for more ambitious targets of a reduction of 55-60% – proposals which still need to be validated by the Council. To this end, last January the Commission proposed the Sustainable Europe Investment Plan, with the particular aim of financing a just transition. The Plan not only includes proposals on financing (for more on which see Chapter 3) but also on creating an enabling framework for investors, notably via a renewed sustainable finance strategy and taxonomy, the use of coordination mechanisms to identify investment needs, and the provision of technical support to public administrators and sustainable project promoters.

Figure 1.18 shows the year-on-year growth of exports and imports in the EU, its Member States and the UK for the second quarter of 2020. We see that both exports and imports fell, as demand plunged around the world. The pandemic resulted in serious disruptions of global supply chains as borders were closed around the world without any harmonisation among the EU Member States. In most Member States the drop in exports was greater than the drop in imports, suggesting that the trade balance contributed negatively to GDP growth.

Figure 1.18 Change in exports and imports of goods and services (change compared to same period in previous year), EU27, Member States and the UK, 2020_Q2



Source: Eurostat, NAMQ_10_GDP CLV_PCH_SM.